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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

BOB STUMP, Chairman
GARY PIERCE
BRENDA BURNS
BOB BURNS
SUSAN BITTER SMITH

In the matter of:

PATRICK LEONARD SHUDAK, a single man,

PROMISE LAND PROPERTIES, LLC, an Arizona limited liability company,

and

PARKER SKYLAR & ASSOCIATES, LLC, an Arizona limited liability company,

Respondents.

DOCKET NO. S-20859A-12-0413

RESPONDENT'S POST-HEARING BRIEF

Respondent Patrick Leonard Shudak ("Shudak") submits his post-hearing brief following the evidentiary hearing that occurred on June 17-19, 2013 concerning the Notice of Opportunity for Hearing Regarding Proposed Order to Cease and Desist, Order for Restitution, for Administrative Penalties and for Other Affirmative Action (the "Notice") filed by the Securities Divisions (the "Division") of the Arizona Corporation Commission (the "ACC") on September 21, 2012.

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INTRODUCTION

As was observed throughout the hearing, the Division's case appears to be unprecedented. The Division *alleges* that Shudak, in his individual capacity and as a control person of Parker Skylar & Associates, LLC ("Parker Skylar") violated the securities registration and securities fraud statutes by offering promissory notes and membership units in Parker Skylar to 17 investors. Parker Skylar, in turn, was a member of Cochise County 1900, LLC, which was organized for the purpose of acquiring and developing approximately 1,900 acres near Bisbee, Arizona (the "Bisbee Property" or "Bisbee Project"). The Bisbee Project began in 2008 and has floundered like so many other real estate projects in Arizona during the Great Recession. However, what makes this case uncommon is that in December 2009 – almost four years ago – the investors in the project, all of whom represented themselves as accredited investors, decided to take control of their own destiny by assuming responsibility of the companies in charge of the development, removing the principals, and voting to develop the project themselves instead of selling the land to recoup their investments. Years later, after the applicable statutes of limitations would have barred any purported private cause of action, the investors now acknowledge that they made a "bad decision" when they decided to develop the project, and they convinced the Division to bring an administrative action in the hopes of unwinding everything that they have done on their own.

The curiosity of the case is best illustrated by the fact that the Division claims that the companies *controlled by the investors for the last three years* committed securities fraud. In effect, the Division has sued the same investors on whose behalf it also seeks restitution, presumably a first-of-its-kind case for the Division.

In addition to the unique nature of the case, there is a great divide between the allegations contained in the Division's Notice, and the evidence that was introduced at the hearing. At the hearing, the Division introduced testimony from three of the 17 investors – Martin Schwank, Craig Swandal, and Steven Berendes. The Division also introduced testimony from two staff members – forensic accountant Andrea McDermitt-Fields and investigator Dulance Morin. The testimony from the three investors varies greatly, and as discussed below, does not support the

Division's claims. The testimony from the Division's staff also fails to support the Division's claims.

The Division did not offer any testimony from the other 14 purported investors (Frank Lamer, Tim Olp, John Schnaible, John McCardle, Jim Peterson, Craig Thomson, Jack Sandner, Timothy Banghart, Gary Bates, Mitchell Lane, William Livingston, Frank Moran, Mick Manley, and Jerry Gruetzemacher). The Division also did not offer any testimony from Shudak. The Division did not ask to depose Shudak during its investigation, and did not ask that Shudak appear to testify at the hearing. Thus, the record is devoid of any evidence of what Shudak said, or did not say, to these 14 investors. Similarly, the record is devoid of any evidence of what those same 14 investors knew, or did not know, before they purportedly made their investments. The lack of any evidence concerning the communications between Shudak and the 14 non-testifying investors dooms the Division's claims relating to their investments.

The Division also has not proven loss causation, a necessary element to its securities fraud claim. Indeed, the record is replete with evidence showing that: (i) there is nothing Shudak did, said, or omitted to say that affected the status of the Bisbee Project; (ii) the collapse of the real estate market and the Great Recession caused whatever losses are now being claimed; (iii) over the last three years the investors could have sold the real estate for a profit or, at a minimum, for an amount that would have mitigated their damages, but instead voted not to sell the real estate or even put it on the market until earlier this year; and (iv) since the investors still own the Bisbee Project, their alleged losses are purely speculative.

The registration claim against Shudak similarly fails. The Division did not offer any evidence of what role, if any, Shudak had concerning the investments made by the 14 non-testifying investors, or even if those investments were "within or from" Arizona. *See* A.R.S. §§ 44-1841 and 44-1842. The evidence also shows that the sales were part of a private offering and, therefore, exempt from any registration requirements under A.R.S. § 44-1844(A)(1). The evidence shows that the investors each acknowledged that they were accredited investors, heard of the opportunity from someone with whom they had a pre-existing relationship and not through any general solicitation, and were given access to whatever information they requested. *See*

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Exhs. S-16 through S-33.

Setting aside the liability issues, the Division's purported "restitution" claim is deficient for a number of reasons. The Division seeks $1,942,000 in restitution on behalf of the 17 investors even though: (i) the Division cannot confirm that all of those funds were paid and received by Shudak or Parker Skylar; (ii) there is no evidence that any of that money failed to go towards the Bisbee Project; (iii) there is no evidence that Shudak (or Parker Skylar) used any of the money for anything other than expenses related to the Bisbee Project; and (iv) the investors continue to hold an ownership interest in the Bisbee Project. The evidence that *does* exist shows that if restitution was awarded, the investors would receive a windfall in the sense that they would retain the benefit of the money used on the Bisbee Project, retain their ownership interest in the Bisbee Project, and receive a full refund for the money they invested.

The Division also appears to seek $200,000 on behalf of Donald and Kim Van Hook (the "Van Hooks") for the loan they made. As the Division acknowledges, the Van Hooks' loan stands alone unlike the other transactions. The Division has not even introduced evidence that the loan should be treated as a security, let alone that any fraud occurred with respect to the loan. Under Arizona law, the loan is not a security, and there is no evidence of fraud.

DISCUSSION

I. THE DIVISION'S FRAUD CLAIM FAILS

The Division alleges that Shudak committed several acts constituting securities fraud under A.R.S. § 44-1991(A). *See* Notice at pp. 11-12. Each of those acts is discussed below:

A. Allegation: Shudak sold at least 29% of Parker Skylar membership interests to investors after 100% of Parker Skylar membership interests had been assigned.

The evidence does not support the allegation that Shudak sold more than 100% of Parker Skylar's membership interests. *See* Notice at ¶57(a). According to the Division's own records, Shudak only sold 88 membership units in Parker Skylar. *See* Exh. S-48. There is no evidence that any consideration was paid for the other 45 units that are part of the Division's calculation. *See id.* Indeed, Morin, the Division's investigator, testified that "[a]fter several interviews" the Division found that Schnaible, Lamer, McCardle, and Peterson did not invest any cash in Parker

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Skylar. Hearing Transcript ("Tr.") 399:12-401:7. The Division attributes 35 of the "133" membership units to those four individuals. *See* Exh. S-48. Thus, based on the Division's own admissions, once those 35 units are deducted from the total, the number of units sold is under 100.

There is evidence that the total number of units sold should be reduced even further. The Division introduced evidence showing that one of the investors, Tim Olp, invested money with Parker Skylar and purportedly received eight membership units, but he also received money back on several occasions. *See* Exhs. S-36, S-38, and S-48. ALJ Stern asked Morin if he knew how McCardle, Schnaible, Lamer, Peterson, or Olp got their membership units, and Morin confessed that he did not know. Tr. 406:17-407:20. Morin conceded that he was unable to confirm how much money was invested and paid to Parker Skylar, and he could not confirm whether any consideration was paid for the purported membership interests in Parker Skylar:

> Q. And you don't know if there was any consideration paid for any of these purported investors if you don't have evidence of monies being received by Parker Skylar, correct?
>
> A. That's correct.

Tr. 392:3-7; *see also* Tr. 390:23-392:7; Exh. S-48. So, while the Division alleges that Shudak assigned 133 out of a possible 100 membership units in Parker Skylar, the record is devoid of evidence establishing the number of membership units actually sold. Based on the Division's own evidence, it appears that each of the investors actually owned *more* of Parker Skylar (on a percentage basis) than what they thought.

In sum, the evidence does not support the Division's allegation that Shudak sold more than 100 membership units in Parker Skylar. ALJ Stern aptly characterized the Division's evidence on this issue as "pretty questionable" and "really roughshod." Tr. at 413:13-14, 414:2-4.

Moreover, as discussed in detail below, Shudak's alleged over-subscription of Parker Skylar membership interests could not, as a matter of law, proximately have caused any of the investors' alleged damages. In 2010, after Shudak voluntarily agreed to resign as the Manager of Parker Skylar and to assign all of his interests in the company to the other members, the

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members abandoned Parker Skylar, decided to continue with the development of the Bisbee Project, exchanged whatever interests they had in Parker Skylar with membership interests in a newly created limited liability company, 1900 Investors, LLC ("1900 Investors"), and then replaced Parker Skylar with 1900 Investors as a member of Cochise County 1900, which owned the Bisbee Project. *See infra* at pp. 12-14. As a result of the investors' securities exchange, they effectively resolved and made irrelevant whatever issues might have existed concerning the number of membership units sold in Parker Skylar. Moreover, when the investors replaced Parker Skylar with 1900 Investors as a member in Cochise County 1900, they took with them the only asset Parker Skylar owned – its membership interest in Cochise County 1900.

Lastly, even if, *arguendo*, Shudak sold more than 100 membership units in Parker Skylar, and the investors had not participated in a securities exchange, the Division's over-simplified analysis fails to take into account the *benefit* that each investor received by the additional funds raised for the Bisbee Project. The Division claims that Shudak sold 133 membership units, which, if true, would have resulted in a dilution of approximately 25% for each unit purchased (*i.e.*, each unit represented 1% of a 100 membership unit company, but under the Division's theory, each unit represented .75% of a 133 membership unit company). *See* Exh. S-48. According to the Division's analysis, there were eight investors who invested a total of $775,000 *after* the first 100 membership units were sold, which amounts to 40% of the total capital raised ($775,000/$1,942,000). *See* Exh. S-48. That money was to be used for the development of the Bisbee Project, and there is no evidence to the contrary. So, the question posed by the Division's allegation is whether the investors were "defrauded" when they thought they were getting a 25% larger percentage in a much smaller company (based on working capital), but instead received a 25% smaller percentage in a 40% bigger company. Of course, based on the Division's own numbers, there can be no serious dispute that all the investors actually benefited by the alleged sale of an additional 33 membership units.

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B. Allegation: Shudak represented to investors that all investor funds would be transferred to Cochise County 1900 to be used for the purchase of the Bisbee Property and expenses related to obtaining a final plat for the Bisbee Project, when in fact, on several occasions, the money was not transferred to or used for the benefit of Cochise County 1900.

The evidence does not support the allegation that Shudak represented to investors that all investor funds would be transferred to Cochise County 1900 to be used for the purchase of the Bisbee Property and expenses related to obtaining a final plat for the Bisbee Project. Notice at ¶57(b). There also is no evidence that such a representation, if made, was false.

As a threshold matter, of the 17 alleged Parker Skylar investors, the record is devoid of any evidence of what Shudak said, or did not say, to 14 of them. Similarly, the record is devoid of any evidence of what those same 14 investors knew, or did not know, before they purportedly made their investments.

With respect to the three investors who did testify, the evidence of fraud similarly does not exist. Schwank invested a total of $361,000. *See* Exh. S-48. He testified that he "became friendly" with Shudak in 2008. Tr. 25:10-20. At some point in time after they became friends, the two discussed the Bisbee Project. Tr. 25:25-26:10. Schwank's understanding was that Shudak was responsible for raising "up to $2.5 million to finance the purchase of the land and [to get] the property to plat." Tr. 33:10-13. His "due diligence" consisted of reading the operating agreements for Cochise County 1900 and Parker Skylar, visiting the site, and asking Alan Thome about the project. Tr. 90:3-92:8. Schwank understood that Thome, not Shudak, was responsible for developing the Bisbee Project. Tr. 91:1-12. After Schwank made his investment, he also knew that work was being done to get the plat approved. Tr. 97:7-11.

Swandal invested $300,000. *See* Exh. S-48. He learned about the Bisbee Project from his "very close friend" Jim Peterson, an Arizona realtor. Tr. 215:14-25. It was Peterson, not Shudak, who suggested that Swandal invest in the Bisbee project. Tr. 216:9-16. Swandal does not recall what information he reviewed on the Bisbee Project before he decided to invest, and was not provided with "a lot of specifics" about it. Tr. 218:21-219:11, 222:5-11. Peterson did explain to Swandal that Thome would be developing the project and "vouched for him," but Peterson did not speak with Thome before making his investment. Tr. 220:3-10, 225:7-13.

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Swandal "was in the midst of flying all over the world," and admits that "unfortunately [he] didn't have a lot of time to do the diligence that [he] should have." Tr. 224:11-20. Instead, he relied on his attorney. Tr. 226:21-227:8.

Berendes invested $100,000. *See* Exh. S-48. He was introduced to Shudak through "a friend of a friend," John Schnaible. Tr. 272:25-273:3. In return for his investment, Berendes understood that he would receive a note that would bear 14% interest and that he would get his interest and principal on the one year anniversary. Tr. 273:10-16. Berendes has "no idea" if he is still a member of Parker Skylar, and does not "have much interest in the LLC units." Tr. 283:13-15, 284:4-16. He said that Shudak gave him "enough paper to choke a horse," but he was "only interested in one thing," which was getting his money back after one year with a 14% return. Tr. 280:2-10.

In sum, the testimony from the three investors reflects that little, or no, due diligence was done before they made their investments, and there is no evidence that Shudak made the representations that the Division alleges he made.

Even assuming Shudak did make the alleged representations, there is no evidence that any such representations were false. The Division failed to prove that any of the investor funds were misdirected or used for anything other than expenses related to the Bisbee Project. McDermitt-Fields, the Division's forensic accountant, did not do any analysis on how the money raised was used. Tr. 334:6-11. She purported to trace only two of the investments, but even with respect to those two investments, she did not know if any of the money was redirected to cover expenses unrelated to the project. Tr. 334:6-341:1. In fact, when asked if all the funds could have been used for legitimate purposes related to the Bisbee Project, McDermitt-Fields acknowledged that she just did not know. Tr. 340:20-341:1. Once again, ALJ Stern offered the best description, when he observed, "There's a lot of money came in here and lot of money went different places, it doesn't always – you can't tell." Tr. 338:10-14. Therefore, the record is devoid of any evidence proving that the money was misappropriated or redirected.

Similarly, Schwank acknowledges that: (i) Parker Skylar could have paid development expenses directly; (ii) he does not know how much money was spent on the Bisbee Project; and

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(iii) he cannot account for all the money deposited, or not deposited, in the Cochise County account. Tr. 126:5-129:2. The record is silent on this issue.

C. Allegation: Shudak did not disclose that a private lender had taken steps to perfect its security interest in all of Parker Skylar's assets and that the lender considered Parker Skylar in default of its obligations to the lender.

The evidence does not support the allegation that Shudak failed to disclose that a private lender had taken steps to perfect its security interest in all of Parker Skylar's assets and that the lender considered Parker Skylar in default of its obligations to the lender. *See* Notice at 57(c). This allegation, which concerns an apparent loan that Nascent Investments, LLC ("Nascent") made on May 22, 2008, has several fundamental evidentiary and factual deficiencies. *See* Exh. S-50.

First, the record is devoid of any evidence of what Shudak said, or did not say, to 14 of the Parker Skylar investors. Similarly, the record is devoid of any evidence of what those same 14 investors knew, or did not know, before they purportedly made their investments.

Second, the Parker Skylar Operating Agreement fully disclosed that Shudak, as Manager, had the authority to borrow money on behalf of the company. Under paragraph 6.3 of the Parker Skylar Operating Agreement, the Manager "has the power, on behalf of the Company, without further authorization from the Members, to do all things necessary or convenient to carry out the business and affairs of the Company, including, without limitation ... (d) entering into contracts and guarantees; incurring of liabilities; borrowing money, issuance of notes, bonds, and other obligations, and the securing of any of its obligations by mortgage or pledge of any of its Property or income." *See* Exh. S-56 at p. 8, ¶6.3.

Third, the record is devoid of any evidence showing: (i) when Nascent took steps to perfect its security interest in Parker Skylar's assets; (ii) when, if at all, Shudak knew that Nascent took steps to perfect its security interest in Parker Skylar's assets; (iii) when Nascent considered Parker Skylar in default; and (iv) when, if at all, Shudak knew that Nascent considered Parker Skylar in default. *See Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (finding that "the danger of misleading buyers must be actually known or so obvious [to the seller] that any reasonable man would be legally bound as knowing, and the

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omission must derive from something more egregious than even 'white heart/empty head' good faith") (internal quotations omitted); *Golden Rule Ins. Co. v. Montgomery*, 435 F. Supp. 2d 980, 983 (D. Ariz. 2006) (recognizing that there can be "no fraud where the omitted information was not within the [defendant's] personal knowledge"); *In re MicroStrategy, Inc. Secs. Litig.*, 148 F. Supp. 2d 654, 665-66 (E.D. Va. 2001) (stating that for securities fraud liability, plaintiffs must demonstrate that "defendants knowingly or recklessly misstated or omitted the alleged material facts").

Fourth, according to the Division's calculations, three of the investors (Frank Lamer, Tim Olp, and Craig Swandal) invested *before* the loan was made, so there was nothing to disclose with respect to those investments. *See* Exh. S-48. In addition, the maturity date on the loan was December 31, 2008, which would have been the date of the earliest default. *See* Exh. S-50. It was only then that Shudak could have even disclosed the default to investors. There were eight investors who made their investments after the maturity date, investing a total of $725,000. *See* Exh. S-48.

Fifth, the investors all represented that they had access to whatever information they deemed necessary and that they conducted their own due diligence. *See* Exhs. S-16 through S-33. Here, on June 6, 2008, Nascent recorded a UCC Financing Statement, listing Parker Skylar as the debtor and reflecting that the financing statement covered all of Parker Skylar's assets. *See* Exh. S-15. The Division's fraud claim cannot rest upon the publicly disclosed loan. *See In re Progress Energy, Inc.*, 371 F. Supp. 2d 548, 552-53 (S.D. N.Y. 2005) (recognizing that it is "well-established law that securities laws do not require disclosure of information that is publicly known"); *see also Drobbin v. Nicolet Instrument Corp.*, 631 F. Supp. 860, 891 (S.D. N.Y. 1986) (stating that "securities laws were not enacted to protect sophisticated [investors] from their own errors of judgment," and finding that where an investor fails to conduct a background check on seller, investor could not blame seller for failure to disclose his criminal convictions and involvement in litigation).

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D. Allegation: Shudak represented that he was qualified and had expertise and experience to raise capital sufficient to Cochise County 1900's operations, and failed to disclose to several investors that several of Shudak's creditors had sued Shudak.

The evidence does not support the allegation that Shudak represented that he was qualified and had expertise and experience to raise capital sufficient to Cochise County 1900's operations, and failed to disclose to several investors that several of Shudak's creditors had sued him. *See* Notice at 57(d).

Again, the record is devoid of any evidence of what Shudak said, or did not say, to 14 of the Parker Skylar investors. Similarly, the record is devoid of any evidence of what those same 14 investors knew, or did not know, before they purportedly made their investments. Of the three investors who did testify, none of them testified that Shudak represented himself as "qualified" or that he "had expertise and experience to raise capital sufficient to Cochise County 1900's operations." *See infra* pp. 7-8.

The record also is devoid of any evidence that Shudak knew that he had been sued by any of his creditors. *See Hollinger*, 914 F.2d at 1569 (finding that "the danger of misleading buyers must be actually known or so obvious [to the seller] that any reasonable man would be legally bound as knowing, and the omission must derive from something more egregious than even 'white heart/empty head' good faith") (internal quotations omitted); *Golden Rule Ins. Co.*, 435 F. Supp. 2d at 983 (recognizing that there can be "no fraud where the omitted information was not within the [defendant's] personal knowledge"); *In re MicroStrategy, Inc. Secs. Litig.*, 148 F. Supp. 2d at 665-66 (stating that for securities fraud liability, plaintiffs must demonstrate that "defendants knowingly or recklessly misstated or omitted the alleged material facts"). The cases all resulted in default judgments, which were entered on December 23, 2008, February 24, 2009, March 6, 2009, June 10, 2009, *see* Exhs. S-40a, S-41a, S-42a, S-43a, well after most of the alleged investments were made.

E. Allegation: Shudak induced an Arizona couple to purchase a note in the principal amount of $200,000 by using a security agreement granting a security interest in Parker Skylar for 50% of Parker Skylar, when at the time, Shudak had transferred 132.5% of Parker Skylar.

The evidence does not support the allegation that Shudak induced an Arizona couple (the

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Van Hooks) to purchase a note in the principal amount of $200,000 by using a security agreement granting a security interest in Parker Skylar for 50% of Parker Skylar, when at the time, Shudak had transferred 132.5% of Parker Skylar. *See* Notice at 57(e).

First, as a threshold matter, the Van Hooks' note is not a security under Arizona law. *See State v. Tober,* 173 Ariz. 211, 841 P.2d 206 (1992). In *Tober*, the Arizona Supreme Court held that for purposes of determining whether a note is a "security" under the registration requirements of A.R.S. §§ 44-1841 and 44-1842, the courts must look to A.R.S. §§ 44-1843, 44-1843.01, and 44-1844, which describe exempt notes and exempt transactions in notes. *Tober,* 173 Ariz. at 213, 841 P.2d at 208. There is no evidence that the Van Hooks' note was anything other than a single, private transaction that was not part of any public offering. Therefore, the note qualifies as an exempt transaction under A.R.S. § 44-1844, and is not a security under *Tober.*

Second, even if the note is a security under Arizona law, there is no evidence of fraud. The Van Hooks did not testify at the hearing, no testimony from them was introduced at the hearing, and the record is devoid of any evidence of what Shudak said, or did not say, to the Van Hooks. Similarly, the record is devoid of any evidence of what the Van Hooks knew, or did not know, before they purportedly made their loan. Accordingly, there is no evidence of any fraud.

II. THE DIVISION HAS FAILED TO PROVE LOSS CAUSATION

Under Arizona law, one of the elements of securities fraud is loss causation. The Division has failed to prove that Shudak's alleged fraud caused the investors' losses. To the contrary, the evidence shows that: (i) the investors took matters into their own hands in 2009 and voted not to sell the real estate, which according to one real estate broker could have been sold for a profit; and (ii) any purported loss is due to the collapse of the real estate market.

To establish loss causation, a plaintiff must show that its loss was proximately caused by the defendant's alleged fraud. *See Grand v. Nacchio*, 214 Ariz. 9, 19, 147 P.3d 763, 773 (App. 2006). ("Loss causation is nothing more than proximate cause ...."). If the loss is due to other factors, such as market decline, depreciation, or subsequent transactions, then loss causation does not exist.

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In November 2009, Swandal and Lamer agreed to send a letter to Thome demanding that Thome agree to sell the property. Tr. 232:10-234:5. According to Berendes, the "vast majority" of the investors wanted to sell the property, and not develop it. Tr. 286:17-287:22. He personally wanted to sell it, as well. Tr. 287:21-22. However, a series of conference calls occurred among the other investors, and a vote was taken not to list the property for sale. Tr. 233:15-234:5. At the time, Peterson, a fellow investor and realtor in Arizona, had the property listed at $5,000 per acre, had "several people interested," and was "certain that if he would have had the opportunity to sell it at the current price he could have moved it." Tr. 242:25-243:19; Exh. 13 at ACC006047. However, Thome let the listing expire. Tr. 242:25-243:19.

In December 2009, Schwank and Tim Olp requested that Shudak resign as a member and the manager of Parker Skylar, and that Shudak assign all of his interests in Parker Skylar to the other members. Tr. 71:4-14, 19-24. On December 15, 2009, Shudak voluntarily resigned from Parker Skylar and assigned all of his interests in the company to the other investors. *See* Exh. R-1. At that point, the members "controlled their own destiny." Tr. 177:23-17:179:24.

Also in December 2009, Schwank and Olp set up 1900 Investors, and Schwank became the manager. Tr. 108:25-109:11, 116:7-15. Schwank did not invite all of the Parker Skylar members to join 1900 Investors; Schwank and Olp excluded any Parker Skylar members who they believed did not contribute cash to Parker Skylar. Tr. 73:6-8, 76:7-10. 1900 Investors also replaced Parker Skylar as member in Cochise County 1900, LLC, and effectively surrendered its membership interests in Parker Skylar. Tr. 113:4-10, 116:4-6. As a result, 1900 Investors caused Parker Skylar to lose its only asset (*i.e.*, its membership interest in Cochise County 1900). Tr. 114:8-13. Any proceeds from the sale of the Bisbee property would go to 1900 Investors, not Parker Skylar. Tr. 114:25-115:7.

The members of 1900 Investors, after replacing Shudak and Parker Skylar, opted not to put the Bisbee property for sale. Tr. 116:16-22. At the time, Peterson thought he could sell one of the parcels for $2,000 per acre and another for $1,500 per acre, grossing approximately $2 million; however, the investors voted not to sell any of the property and to continue to develop it. Tr. 116:16-22, 247:19-249:20, Exh. 13 at ACC006046. Swandal agrees that "in hindsight, that

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proved not to be a very sound strategy." Tr. 250:7-9. Schwank admits that the decision not to sell the property was "a bad judgment call" and "a bad decision." Tr. 117:5-21; 180:5-16.

Ultimately, in December 2012, according to Schwank, the investors "lost faith" in Thome, removed him as the manager of Cochise County 1900, and replaced him with Schwank. Tr. 137:15-138:9, 160:5-19, 167:17-170:21. Thome was unsuccessful in finding developers, unsuccessful in finding additional capital, he did not answer questions posed to him about the development, and "nothing good was happening." Tr. 167:17-170:21.

1900 Investors waited until early 2013 (February or March) to list the Bisbee Property for sale. Tr. 77:3-5, 122:23-123:23. The original listing price was approximately $2.5 million. *Id.* In June 2013, the price was lowered to $1,699,000. Tr. 77:6-7.

Based on the evidence presented at the hearing, there is every reason to believe that the investors could have recouped their investment, and very likely made a profit, if they had chosen to sell the Bisbee Property instead of develop it. That same evidence proves that Shudak's alleged fraud did not cause the investors' speculative losses. As Schwank acknowledged, "Nothing [Shudak] did or didn't do had any impact on Parcel A, Parcel B or Parcel C as they sit there today." Tr. 140:3-12.

III. THE DIVISION'S REGISTRATION CLAIM FAILS

The evidence does not support the Division's allegations that Shudak violated the registration requirements of A.R.S. §§ 44-1841 and 44-1842. The investments were part of a private offering and, therefore, exempt from registration under A.R.S. § 44-1844(A)(1).

In determining whether investments are part of a private offering and, therefore, exempt from the registration requirements, courts consider the following factors: (1) the number of offerees; (2) the sophistication of the offerees; (3) the size and manner of the offering; and (4) the relationship of the offerees to the issuer. *See Mary S. Krech Trust v. The Lakes Apartments*, 642 F.2d 98, 101 (5th Cir. 1981). Here, each of these factors reflects that the investments were part of a private offering:

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A. The Number of Offerees

There is no rigid limit to the number of offerees to whom an issuer could make a private offering. *See SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953). While the number of offerees, itself, is not decisive, *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 901 (5th Cir. 1977), "the more offerees, the more likelihood that the offering is public." *See Hill York Corp. v. Am. Intern. Franchises, Inc.*, 448 F.2d 680, 688 (5th Cir. 1971).

Here, the evidence shows that there were only 17 investors. This evidence supports the finding that the investments were part of a private offering and, therefore, exempt from registration. *See Krech Trust*, 642 F.2d at 102-103 (finding offering to be private where there were 15 offerees); *see also Doran*, 545 F.2d at 901 (recognizing that the difference between one and eight offerees is "relatively unimportant" to the private offering analysis).

B. The Sophistication of the Offerees

The Division introduced evidence showing that the offerees signed Investor Suitability Questionnaires indicating that they were all accredited investors, and represented in the Investment Purchase Agreements that they, among other things: (i) received and reviewed the information provided to them; (ii) had a reasonable opportunity to ask questions and all questions were answered to their satisfaction; (iii) conducted whatever investigation they deemed necessary; (iv) evaluated the merits and risks of the investment; and (v) understood that the investment was speculative and involved certain risks. *See* Exhs. S-16 through S-33. Thus, based on their own admissions, the offerees were all sophisticated. This same evidence also supports the finding that the investments were part of a private offering and, therefore, exempt from registration. *See Krech Trust*, 642 F.2d at 102-103 (finding offering to be private where investors completed questionnaires stating their "net worth and financial sophistication").

C. The Size and Manner of the Offering

If an offering is small and is made directly to the offerees "rather than through the facilities of public distribution such as investment bankers or the securities exchanges," a court is more likely to find that it is private. *See Hill York Corp.*, 448 F.2d at 689. Here, each of the offerees acknowledged in their Investment Purchase Agreement that the solicitation was

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"directly communicated to me and any Advisors ..., [and] [a]t no time was I presented with or solicited by or through any leaflet, public promotional meeting, circular, newspaper or magazine article, radio or television advertisement or any other form of general advertising ...." *See* Exhs. S-16 through S-33 (Investment Purchase Agreement, Additional Terms and Conditions, ¶1(i)). Given the relatively small nature of the offering, and the private manner of the solicitations, this factor further supports the finding that the investments were part of a private offering and, therefore, exempt from registration. *See Krech Trust*, 642 F.2d at 102-103 (finding offering to be private where offering was made through brokers who directly communicated with only a select group of investors).

D. The Relationship Between the Issuer and the Offerees

As discussed above, each of the offerees acknowledged that they were given access to whatever information about the issuer they deemed necessary. *See supra* pp. 15-16. Therefore, this factor supports the finding that the investments were part of a private offering and, therefore, exempt from registration. *See Krech Trust*, 642 F.2d at 102-103 (finding offering to be private where offerees were given the opportunity to ask questions and review relevant documents).

Because each of the above factors reflects that the investments were part of a private offering, the investments were exempt from registration under A.R.S. § 44-1844(A)(1). The Division's registration claim, therefore, fails.

IV. THE DIVISION IS NOT ENTITLED TO A RESTITUTION AWARD

The Division apparently seeks $1,942,000 in restitution, which represents a full refund of the 17 investors' investments. However, neither the Division's evidence, nor Arizona law provides a basis for such an award.

Section 44-2032 of the Arizona Securities Act (the "Act") provides that where a party has violated the Act, the ACC may require the party to "provide restitution." *See* A.R.S. § 44-2032. The ACC must determine the necessity for, and amount of, such restitution consistent with the well-defined meaning of restitution under Arizona law. *See McIntyre v. Mohave Cnty.*, 127 Ariz. 317, 318 620 P.2d 696, 698 (1980) (recognizing that where it does not appear

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from the context that a different meaning is intended, "[w]ords and phrases in statutes shall be given their ordinary meaning").

Under Arizona law, restitution is awarded where "it would be inequitable or unjust" for a party to retain a "benefit" from another without compensation. *See Murdock-Bryant Constr., Inc. v. Pearson*, 146 Ariz. 48, 54, 703 P.2d 1197, 1203 (1985). The "mere receipt of a benefit is insufficient" to justify restitution. *See id.* The purpose of restitution in circumstances such as these is to "eliminate profit from wrongdoing, while avoiding, so far as possible, the imposition of a penalty." *See* Restatement (Third) of Restitution and Unjust Enrichment § 51(4); *see also Webster v. Culbertson*, 158 Ariz. 159, 162, 761 P.2d 1063, 1066 (App. 1996) (recognizing that in the absence of law to the contrary, Arizona follows the Restatement). Therefore, where, as here, "restitution is intended to strip [a party] of a wrongful gain," restitution is calculated by determining "the amount of the profit wrongfully obtained." *See* Restatement (Third) of Restitution and Unjust Enrichment § 49(4); *see also Amerco v. Shoen*, 184 Ariz. 150, 155, 907 P.2d 536, 541 (App. 1995) (finding the restitution due to be the amount of improper gains). The party seeking restitution has the "burden of producing evidence permitting at least a reasonable approximation of the amount of the wrongful gain." *See* Restatement (Third) of Restitution and Unjust Enrichment § 51(5)(d).

The record is devoid of any evidence that Shudak has benefitted – let alone wrongfully obtained profits – from the investments. There is no evidence that any of the funds paid by the investors: (i) were received by Shudak (or Parker Skylar); (ii) failed to go towards the Bisbee project; or (iii) were used by Shudak (or Parker Skyler) for anything other than expenses related to the Bisbee Project. Moreover, even if the ACC finds that Shudak has benefitted in some way, the Division still is not entitled to restitution in the amount that it apparently seeks. The Division's recovery in restitution is limited to "the amount of profit [Shudak has] wrongfully obtained." *See* Restatement (Third) of Restitution and Unjust Enrichment § 49(4); *see also Amerco*, 184 Ariz. at 155, 907 P.2d at 541. The Division has not produced any evidence permitting even a "reasonable approximation" of wrongfully obtained profit.

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The Division likely will argue that these truths should be ignored and that restitution should be calculated under Arizona Administrative Code R14-4-308(C)(1). *See* A.A.C. R14-4-308(C)(1) (providing that upon a finding of liability under the Arizona Securities Act, the ACC may order restitution in the amount of "[c]ash equal to the fair market value of the consideration" that the buyer paid, plus interest, less any "principal, interest, or other distributions" that the buyer received). The construction of restitution given by the agency in this section of the code is invalid and should not be followed, because it fails to comport with the ordinary meaning and purpose of restitution under Arizona law. *See Sharpe v. Ariz. Health Care Cost Containment Sys.*, 220 Ariz. 488, 495, 207 P.3d 741, 748 (App. 2009) ("[I]f the construction given by [an] agency is not consistent with the enabling legislation, the interpretation – whether expressed in regulation, policy, or otherwise – is invalid."). This section of the code does not require a showing of any "benefit," nor does it limit restitution to a party's wrongfully obtained profits. In fact, under this section of the code, the Division would be able to recover the same amounts on behalf of the investors that it could through rescission, but without having to follow the procedures necessary to effectuate a rescission. *See* A.A.C. R14-4-308(B) (providing the same amount of compensation for rescission as A.A.C. R14-4308(C) provides for restitution). This is contrary to Arizona law and, therefore, should not be permitted.

Setting aside the legal defects with the Division's request for restitution, the Division also has failed to prove a valid restitution figure. During the hearing, there was some confusion over the amount of restitution being sought by the Division. The Division apparently is seeking restitution in the amount of $2,142,000, which includes the Van Hooks' loan, but they only have bank records showing deposits of $1,675,500. *See* Exh. S-57. Morin, the Division's own investigator, testified that "[a]fter several interviews" the Division found that Schnaible, Lamer, McCardle, and Peterson did not invest any cash in Parker Skylar, Tr. 399:12-401:7, yet the restitution figure includes $128,000 from Lamer. *See* Exh. S-57. In response to a direct question from ALJ Stern, Morin testified that this amount should not be included in any restitution award. *Id.* ALJ Stern described the obvious problem with the Division's restitution calculations as

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follows:

> I just still find it somewhat – I don't know what a good term would be. Usually when you want to order an amount to be paid in restitution, you have a dollar amount that you know is valid and it's been proven. Here we have claims of investments, but no track of the money. ... So, we're not entirely sure if, in fact, the monies were invested. ... I don't know, I don't recall ever seeing something quite like this.

Tr. 332:2-13.

For the foregoing reasons, the Division is not entitled to restitution. The Division has not carried its burden of proving that Shudak has benefitted – let alone wrongfully profited – from the investments. Requiring Shudak to pay restitution in the amount that the Division seeks would only penalize Shudak and create a windfall for the investors, who would retain the benefit of the money used on the Bisbee Project, retain their ownership interest in the Bisbee Project, and receive a full refund of their investments. This is not what restitution is designed to accomplish.

CONCLUSION

For the foregoing reasons, the Division's claims should be denied and this administrative action should be dismissed in its entirety.

DATED this 9th day of August, 2013.

GREENBERG TRAURIG, LLP

By: _____
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ORIGINAL and 13 copies of
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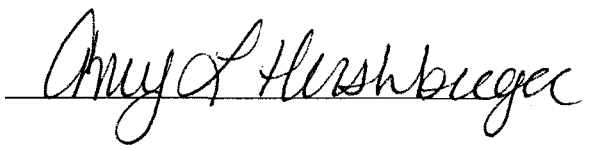

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